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No. 04-181

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

IRVING PULP & PAPER, LIMITED d/b/a IRVING PAPER,

Petitioner,

v.

CAPITAL FACTORS, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF

GUY B. MOSS
BINGHAM MCCUTCHEN LLP
150 Federal Street
Boston, MA 02110
(617) 951-8000

G. ERIC BRUNSTAD JR.
Counsel of Record
BINGHAM MCCUTCHEN LLP
One State Street
Hartford, CT 06103
(860) 240-2700

Attorneys for Petitioner

RULE 29.6 STATEMENT

Petitioner's Corporate Disclosure Statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that Statement.

TABLE OF CONTENTS

Page

Rule 29.6 Statement i

Table of Contents ii

Table of Cited Authorities iii

I. The Decision of the Court Below Squarely Conflicts with the Decisions of Other Courts of Appeals. 2

II. The Proper Construction of Section 364(e) Is Unquestionably of Sufficient Importance to Warrant Review in this Court 7

III. Certiorari Is Also Warranted Because the Decision Below Is Wrong on the Merits ... 9

Conclusion 10

TABLE OF CITED AUTHORITIES

Page

Federal Statutes:

11 U.S.C. § 362(b) 5

11 U.S.C. § 362(c) 5

11 U.S.C. § 362(d) 5

11 U.S.C. § 363(m) 3

11 U.S.C. § 364 5

11 U.S.C. § 364(a) 5

11 U.S.C. § 364(e) ..... *passim*

REPLY BRIEF FOR PETITIONER

There is no real dispute that this case squarely presents a three-way circuit conflict over whether and to what extent section 364(e) of the Bankruptcy Code protects an order approving a credit transaction from subsequent appellate modification. Attempting to sidestep the issue, Capital argues that review is not warranted because the bankruptcy court did not properly enter the Vendor Order under section 364 of the Bankruptcy Code. (Cert. Op. at 14-18). But that is both untrue and beside the point. Regardless of whether the bankruptcy court properly entered its order, the question presented — and the issue over which the courts of appeals are divided — is whether an appellate court has the authority to overturn such an order under section 364(e) absent a stay pending appeal or the creditor's bad faith.

As demonstrated in Irving's petition, other courts of appeals have concluded that, under section 364(e), an appellate court may not overturn an order of the bankruptcy court authorizing the priority payment of a creditor's pre-petition claim in exchange for the creditor's post-petition extension of credit unless the prerequisites of section 364(e) are satisfied. (Pet. at 12-17). In contrast, the court below concluded that section 364(e) does not impose these limitations on appellate review of the same kind of order. Specifically, the Seventh Circuit concluded that it could exercise plenary review over the Vendor Order and overturn its priority payment authorization even though Irving had already extended credit. (Pet. App. 4a, 9a). The Seventh Circuit's resolution of the question presented thus falls squarely within the conflict among the courts of appeals over the proper application of section 364(e).

Ultimately, Capital does not deny that Irving extended post-petition credit to Kmart in exchange for Kmart's priority treatment of Irving's pre-petition invoice in accordance with

the express terms of the Vendor Order. Nor does Capital dispute that the court below actually decided the question presented or the existence of a three-way circuit conflict on this question. Likewise Capital has no response to Irving's showing that the issue is important, that this Court's resolution of the question presented is outcome-determinative, or that the court below was wrong on the merits. Similarly, Capital does not dispute the enormous cost and inequity involved in the current prosecution of thousands of lawsuits against Irving and other trade vendors arising from the decision of the court below seeking the return of approximately $300 million in payments that Kmart made under the Vendor Order. Because the question presented is vitally important and recurring, and is one over which the courts of appeals are intractably divided, certiorari should be granted.

I. The Decision of the Court Below Squarely Conflicts with the Decisions of Other Courts of Appeals.

Section 364(e) is directed exclusively to the authority of an appellate court to review the decision of a bankruptcy court approving the terms of a financing transaction. In this case, the court of appeals expressly acknowledged that section 364(e) does "forbid revision of transactions completed under judicial auspices." (Pet. App. 4a). Nevertheless, the court separated Kmart's ability to obtain post-petition trade credit from *the terms* of the credit transaction as a whole — specifically Kmart's elevation of the vendors' pre-petition claims to post-petition priority status in exchange for their agreement to extend credit. The court concluded that section 364 "authorizes the debtor to obtain credit (as Kmart did), but has nothing to say about . . . priorities among creditors." (Pet. App. 9a). Accordingly, the court exercised plenary review over the treatment of the vendors' pre-petition claims under the Vendor Order

irrespective of any question of good faith or Capital's failure to obtain a stay, holding that "the critical-vendors order cannot stand." (Pet. App. 14a).

On this vital question, the decision of the court below falls squarely within the circuit split identified in Irving's petition. As noted, the Ninth and Sixth Circuits have ruled that, absent bad faith or a stay pending appeal, section 364(e) shields from appellate review the terms of a credit transaction that includes the priority treatment of the creditor's pre-petition claim regardless of whether the transaction was wrongfully approved. (Pet. at 9-11). In contrast, the Eleventh Circuit, together with the court below, have ruled that section 364(e) provides no such protection. (Pet. at 14-17).

As further noted in the Petition, the decision of the court below likewise conflicts with the decisions of the Third and Tenth Circuits under section 364(e). (Pet. at 15-17). Moreover, the divergent approaches taken by the courts of appeals under section 364(e) mirrors a larger split of authority under section 363(m) — a companion provision of the Bankruptcy Code that is virtually identical to section 364(e). (Pet. 17-20). Within this larger group of cases, the decision of the court below conflicts with the decisions of *ten* other courts of appeals applying the nearly identical standards of sections 364(e) and 363(m). Because the Seventh Circuit's decision in this case falls squarely within the scope of an existing and intractable circuit conflict, the petition should be granted.

Rather than address either the merits of the decision of the court below under section 364(e), the question presented, the split of authority among the circuits, the importance of the question, or any other relevant consideration, Capital fixates on what it contends are flaws in the Vendor Order itself. But the merits of the Vendor Order are beside the point.

Even assuming that a bankruptcy court's financing order arguably lacks merit, the question presented centers on an *appellate* court's authority to review the merits of the order absent a stay or the creditor's lack of good faith.

Critically, Capital does not (and cannot) deny that the Seventh Circuit actually decided the question presented in conflict with the decisions of other courts of appeals. Instead, Capital argues that the Seventh Circuit essentially decided a moot point because Capital believes that the case could be disposed of on the ground that the bankruptcy court did not properly enter or label the Vendor Order as a "financing order." (Cert. Op. at 15). This argument, however, is meritless and provides no basis for denying the petition.

Critically, Capital nowhere denies that the Vendor Order is, in fact, a financing order. Indeed, the order itself lays this issue to rest. By its terms, the Vendor Order expressly authorized Kmart to pay Irving's pre-petition claim in exchange for Irving's agreement to extend post-petition trade credit. (Pet. App. 30a-33a).

Moreover, Capital does not (and cannot) deny that, acting in accordance with the provisions of the order, Irving actually extended post-petition trade credit to Kmart in exchange for Kmart's payment of Irving's pre-petition invoice. As Irving accurately summarized in its petition:

> After the bankruptcy court entered the Vendor Order, Irving agreed to the provisions of the Order and commenced shipping tens of millions of dollars worth of goods to Kmart on favorable credit terms. In turn, Kmart paid Irving's pre-petition invoice in the amount of approximately $3.5 million as an expense of administration and thereafter Kmart paid Irving for its post-petition

> shipments. In addition, Irving relinquished any lien or reclamation rights that it had with regard to the goods that it had shipped.

(Pet. at 5). Thus, regardless of whether the parties might have consummated a different transaction with different pricing and payment terms, Irving in fact complied with the terms of the order and extended post-petition credit to Kmart in exchange for the priority payment of its pre-petition claim.

Section 364(e) plainly applies to the transaction that the bankruptcy court approved between Irving and Kmart in this case. Under section 364, a debtor may be authorized to incur post-petition debt, or obtain post-petition credit, in one of two basic ways. First, the debtor may obtain credit in the ordinary course of its business without a court order. *See* 11 U.S.C. § 364(a); (Pet. 2-3). Second, the debtor may obtain credit other than in the ordinary course of its business pursuant to a court order. *See* 11 U.S.C. §§ 362(b), (c) & (d); (Pet. 3-4). Section 364(e) shields both situations from appellate intervention, expressly providing that

> [t]he reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended credit in good faith . . . unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

11 U.S.C. § 364(e). Significantly, section 364(e) applies not only to the approved financing itself, but also, without limitation, to any priority or lien granted as part of the financing transaction.

Whether or not the bankruptcy court's authorization of the transaction in this case was necessary or proper is simply irrelevant if section 364(e) applies to shield review of the merits of the Vendor Order in the absence of a stay or the creditor's bad faith. Critically, that is not only the question decided below, it is also one on which the courts of appeals are divided and is likewise the question presented in Irving's petition.

Capital suggests that the Vendor Order was not a true financing order because the standard credit provisions of the order *could* have been altered through negotiation. (Opposition at 15). Capital asserts that, under the order, Kmart might have agreed to pay the pre-petition invoice of a particular creditor without obtaining the creditor's agreement to extend post-petition credit on terms favorable to Kmart if necessary to prevent irreparable harm to Kmart's estate. (*See* Pet. App. at 33a). This argument, however, is also meritless and supplies no ground for denying the petition. As noted, Irving and Kmart in fact complied with the standard financing provisions set forth in the Order, and not the alternative, hypothetical transaction that Capital identifies.

Further, Capital does not contend that any other trade vendor actually had its pre-petition invoice paid without agreeing to extend credit post-petition to Kmart as contemplated by the standard provisions of the order. Moreover, Capital does not deny that resolution of the question presented is outcome-determinative. In this case, if Irving prevails, it may keep the approximately $3.5 million that it received. On the other hand, if Irving loses in this Court, then it faces having to return the payment (as do thousands of other trade creditors who are similarly situated). Irving obviously does not seek an advisory opinion. Instead, Irving seeks the resolution of a live controversy over which the courts of appeals are intractably divided.

Capital argues further that review is not warranted on the theory that it is possible that Irving may not have extended its post-petition trade credit in "good faith." (Cert. Op. at 18-20). This argument, however, actually illustrates why certiorari should be granted. The concept of good faith is relevant only if the appellate court first recognizes the statutory restrictions that section 364(e) imposes because it is section 364(e) that imposes the good faith requirement in the first place as a prerequisite to appellate review. In this case, the Seventh Circuit did not address the question of good faith because the court applied a plenary standard of review in conflict with the decisions of other courts of appeals.

In addition, Capital's argument is immaterial because Capital never challenged Irving's good faith in any proceeding below and has no grounds for asserting that Irving acted in bad faith because none exist. The best that Capital can offer is its speculation that, "to the extent" Irving may have taken certain actions, then perhaps Irving's good faith might be challenged. (Cert. Op. at 19). But Capital cannot say that Irving actually did anything wrong (because Irving did not) and Capital's claim is thus purely imaginary. Moreover, to the extent that any question of good faith remains, it is separable and may be addressed on remand if necessary.

II. The Proper Construction of Section 364(e) Is Unquestionably of Sufficient Importance to Warrant Review in this Court.

Capital has no answer to Irving's demonstration that the question presented is of vital importance to the administration of business reorganization cases. Every day, creditors extend millions of dollars worth of essential credit to chapter 11 debtors in reliance on the protections of section 364(e). Unlike credit transactions between lenders and financially

healthy obligors outside the bankruptcy setting, credit transactions in chapter 11 cases involve insolvent debtors and are subject to any creditor's objection in the bankruptcy court. Lenders understand this, and thus appreciate that, without the protections of section 364(e), their credit transactions would be subject to the uncertainty of unbridled appellate scrutiny. In enacting the Bankruptcy Code, Congress concluded that this uncertainty would chill the provision of necessary credit in bankruptcy, and crafted section 364(e) accordingly.

The clear and obvious effect of the decision below is to undo the protections that Congress has prescribed. Creditors faced with the prospect of having their transactions undone on appeal after they have extended credit will be far less likely to lend to chapter 11 debtors. Worse, creditors who are sued for the recovery of the payments that they received following an appellate court's reversal of a transaction on which they relied will have even less incentive to return to the bankruptcy credit market.

Likewise, Capital has no response to Irving's showing regarding the enormous cost and inequity arising from the thousands of lawsuits that have been brought against the numerous trade vendors such as Irving who extended credit and received payment of their pre-petition invoices on the strength of the Vendor Order. By disregarding the protections of section 364(e), the court below has unleashed a flood of litigation that is only likely to be repeated in future chapter 11 proceedings. Moreover, for a significant number of the trade vendors in this case, being forced to return the payments that they have received may well precipitate their own bankruptcy filings. This is precisely an inequity that section 364(e) was designed to avoid and review in this Court is necessary to address this serious problem.

III. Certiorari Is Also Warranted Because the Decision Below Is Wrong on the Merits.

Capital also has no answer to Irving's demonstration that the decision of the court below is wrong on the merits. The Seventh Circuit's ruling in this case effectively leaves nothing of substance to section 364(e) because, under the court's standard, as long as the court disagrees with the payment terms in a financing order, it may reverse the order even though the lender acted in good faith and the appellant failed to obtain a stay pending appeal. In contrast, most other courts that have addressed the issue under section 364(e), and *every* other circuit to have addressed the same issue under section 363(m), have concluded that an appellate court's authority is circumscribed by the statutory restrictions.

Not surprisingly, the payment terms of a financing transaction are the ones most likely to engender controversy in a disputed transaction, rather than the bare fact that the debtor has obtained credit. Likewise, for the creditor, the payment terms are most likely to be the most important aspect of the transaction. The Bankruptcy Code provides no warrant for a court of appeals to second-guess the price of credit in bankruptcy absent the lender's bad faith or the issuance of a stay pending appeal before the transaction is consummated. The Seventh Circuit's decision to the contrary is not only unwarranted under the Code, it defies Congress' assigned roles regarding the supervision of credit transactions in bankruptcy settings.

CONCLUSION

This case presents a frequently recurring question that is essential to the orderly operation of the bankruptcy laws. This case likewise presents a question of law over which the courts of appeals are staunchly divided. For the foregoing reasons, as well as those set forth in the petition, Irving respectfully requests that the Court issue a writ of certiorari to review the decision of the Seventh Circuit.

Respectfully submitted,

GUY B. MOSS
BINGHAM MCCUTCHEN LLP
150 Federal Street
Boston, MA 02110
(617) 951-8000

G. ERIC BRUNSTAD JR.
Counsel of Record
BINGHAM MCCUTCHEN LLP
One State Street
Hartford, CT 06103
(860) 240-2700

Attorneys for Petitioner